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Subject: RE: Conference call to discuss comments on rebuttal draft

-- My plane arrives at 11:45, so I should be at my desk sometime after 1:00; I am also available any time Tuesday. Here are some potentially interesting quotes/cites:

1. "Petitioner's next argument is that he is using a hybrid method of accounting. Hybrids are permissible if they are used consistently and clearly reflect Income. Section 1.446-1(c)(2)(ii), Income Tax Regs. However, a hybrid method which uses the cash method to report expenses must also use the cash method to report income. It is well settled that taxpayers may not accrue receipts and treat expenditures on a cash basis, or vice versa. *Mass. Mutual Life Ins. Co. v. United States* [3 USTC ¶ 1045], 288 U.S. 269, 274 (1933). Petitioner has used the cash method to report his expenses and, therefore, cannot use anything other than the cash method to report his income. Otherwise, petitioner would be able to currently deduct expenses while deferring income."

Gustafson v. Commissioner, T.C.Memo. 1988-82.

2. "Petitioner concedes that, absent the prior examination and approval of petitioner's method of accounting, this case would be controlled by *Connors, Inc. v. Commissioner*, 71 T.C. 913 (1979). In *Connors*, this Court held that section 446(c)(4) and section 1.446-1(c)(1)(iv)(a), Income Tax Regs., require a taxpayer, who uses the cash method of accounting for reporting items of gross income for his trade or business, to use also the cash method for reporting items of expenses even though he uses a hybrid method of accounting with respect to other items." ***Pierce Ditching Co. v. Commissioner*, 73 T.C. 301, 304-5 (1979).**

3. "The issues in this case concern taxpayer's method of accounting during the tax years in question. Characterizing this method as a hybrid of cash and accrual methods, the tax court found that Record Wide reduced its inventory when items were shipped to its customers, but recorded sales upon actual receipt of payment.² The Commissioner concluded that this hybrid method did not clearly reflect taxpayer's income,³ see 26 U.S.C. § 446(b), and recalculated tax liability for the years 1972, 1973 and 1974, on an accrual basis, resulting in the assessment of deficiencies in the amounts of \$92,056.99, \$34,444.54 and \$21,232.29, respectively.⁴

"Record Wide defends its accounting method as consistent with its unique business practices. It is established, however, that the Commissioner has broad discretion to

evaluate and modify a taxpayer's accounting method in order to insure the clear reflection of income, and that the taxpayer has the heavy burden of proving that the Commissioner's determination is plainly arbitrary. *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 532-33, 99 S.Ct. 773, 780-81, 58 L.Ed.2d 785 (1979); *Clement v. United States*, 580 F.2d 422, 430 (Ct.Cl.1978), cert. denied, 440 U.S. 907, 99 S.Ct. 1214, 59 L.Ed.2d 455 (1979). The regulations clearly mandate the use of an accrual accounting method for businesses that maintain inventories, unless the Commissioner, in his discretion, authorizes an alternate method. Treas. Reg. § 1.1446-1(c)(2). The tax court concluded, and we agree, that Record Wide failed to establish that the Commissioner abused his discretion by requiring the use of an accrual method to compute Record Wide's tax liability." **Record Wide Distributors, Inc. v. Commissioner, 682 F.2d 204 (1982).**

4. "The petitioner argues that he is entitled to use a hybrid method of accounting, under the authority of section 1.446-1(a)(2), Income Tax Regs. His theory is, apparently, that he should be permitted to accrue currently, as a liability, amounts owed by him to himself on account of his labors, but include the value of such labor in income only when (754) and if such labor gives rise to cash income in the future. This argument is totally without merit. For one thing, we have found that the petitioner incurred no liability, in favor of himself or anyone else, to pay for the value of his services. For another, the regulations specifically provide:

"a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method * * * in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business. [Sec. 1.446-1(c)(1)(iv), Income Tax Regs.]

"There is no evidence that the petitioner contemplated using anything but a cash method of accounting for any income which might be derived from his mineral operations. Finally, we cannot see how the method used by the petitioner would clearly reflect income. See sec. 446(b); sec. 1.446-1(a)(2), Income Tax Regs. For all the foregoing reasons, we hold that the petitioner may not account for his labors in the manner claimed.

"Accordingly, the respondent properly disallowed the deductions for the research work, and for the work to maintain the mining claims, performed by the petitioner. Our conclusion avoids the necessity of passing on the correctness of the petitioner's valuation of such labor." **Rink v. Commissioner, 51 T.C. 746 (1969).**

5. "The first issue for decision is whether petitioners may deduct more than \$51,203 for repairs expenses for 1994. Petitioners contend that they may deduct \$114,823 for repairs expenses for 1994. Petitioners did not report income until they received it, but they deducted some expenses before they paid them. Petitioners contend that this is a proper hybrid method of accounting which they have consistently and properly used to compute and report petitioner's income and expenses from his logging business.

Petitioners also contend that respondent's determination was an abuse of discretion because the cash method of accounting does not clearly reflect petitioner's income from the logging business.

"We disagree. First, petitioners did not explain why the cash method would not clearly reflect their income. Second, petitioners did not use a valid hybrid method of accounting. Petitioners improperly reported income on the cash method and related expenses on an accrual method. See sec. 1.446-1(c)(1)(iv), Income Tax Regs. A taxpayer's method of accounting that is plainly contrary to the regulations does not clearly reflect income. See *Thor Power Tool Co. v. Commissioner* [79-1 USTC ¶ 9139], 439 U.S. 522, 523, 533 (1979)." **Grider v. Commissioner, T.C.Memo. 1999-417.**

6. "In the present case, petitioner contends that it employs a "hybrid" system of accounting as authorized by regulation section 1.446-1(a) (2). Under its system, petitioner accounts for most of its transactions on a cash receipts and disbursements basis. However, deductions for its contributions to its pension and profit-sharing plans are accounted for under the accrual method.[\[6\]](#)

"Because it accounts for its contributions on an accrual basis, and because for each of the years in issue it actually paid such contributions prior to the due date of its returns, pursuant to section 404(a)(6), petitioner maintains that it is entitled to a deduction for the year of accrual. We disagree.

"Generally section 446(c) allows a taxpayer to compute its taxable income under either a cash or an accrual method of accounting. Subsection (4) of section 446(c) authorizes the use of a hybrid system of accounting if it is "permitted under regulations prescribed by the Secretary." In this regard, the regulations permit the use of a combination of a cash and accrual system of accounting if such system clearly reflects income and is consistently used. See section 1.446-1(c)(1)(iv), Income Tax Regs. However, the regulations restrict the use of a hybrid system in certain cases. In particular, regulation section 1.446-1(c) (1) (iv) (a) provides in pertinent part:

a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business.

"Here petitioner utilizes the cash method of accounting in computing gross income from its trade or business, and so it must also use the cash method in accounting for any expenses, such as compensation, which relate to such business. Included within the term "compensation" are any payments to a pension or profit-sharing plan. See section 404(a). Accordingly, petitioner must use the cash method to account for any expenses relating to its contributions, and is therefore not entitled to rely on section 404(a)(6) in determining the proper year for deducting such contributions." **Cain-White & Co., T.C.Memo. 1978-438.**

7. “The facts of this case fall squarely within section 1.446-1(c)(1)(iv)(a), Income Tax Regs., which provides, in pertinent part, as follows:

* * * a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business.

“In the instant case, petitioners have not only used the cash method of accounting in computing gross income from the rental of the property, but they have used the cash method in computing all of the expenses therefrom, except real estate taxes. Consequently, petitioners must also account for real estate taxes on the cash basis. See also, *Massachusetts Mutual Life Insurance Co. v. United States* [3 USTC ¶ 1045], 288 U.S. 269, 273-274 (1933); *Miele v. Commissioner* [Dec. 36,055], 72 T.C. 284, 291 (1979); *Connors, Inc. v. Commissioner* [Dec. 35,900], 71 T.C. 913, 916 (1979). Since petitioners did not pay the real estate taxes attributable to the property during the years in issue, respondent properly disallowed their claimed deductions for those years. Secs. 1.446-1(c)(1)(i) and 1.461-1(a)(1), Income Tax Regs.” **Brunton v. Commissioner, T.C.Memo. 1982-166.**